

# Value added tax (VAT): certain temporary provisions concerning VAT rates

2007/0136(CNS) - 05/07/2007 - Document attached to the procedure

This Communication presents the main conclusions of a study on the impact of reduced rates of VAT, provides material for discussion and explores ways forward in the field of reduced VAT rates.

To recall, under the current system on VAT rate structure, Member States are required to apply a single standard rate of at least 15% and may have a maximum of two reduced rates set no lower than 5%, which Member States may apply at their discretion, to the categories of goods and services listed in Annex III to Council Directive 2006/112/EC (the VAT Directive). This basic structure, which applies to all Member States, is complicated by the plethora of different temporary derogations granted to individual Member States outside the general scheme.

Council Directive 2006/18/EC sees the third prolongation of the experiment on reduced rates for labour-intensive services till the end of 2010, and a possibility to apply a reduced rate on district heating under the same procedure as for natural gas and electricity. Council Directive 2006/18/EC included a request to the Commission to present an overall assessment report on the impact of reduced rates. The study examined the impact of reduced VAT rates and of derogations, not only for locally supplied services, but also more globally.

The Commission examines the results of the study in detail. The study stresses that **a single VAT rate** is by far the **best policy choice** from a purely economic point of view. A move towards more uniform rates has thus considerable advantages. First, a less complicated rate structure would generate substantial savings in compliance costs for business and tax administrations. Second, it could reduce distortions in the functioning of the internal market. Third, it is likely to slightly improve "consumer welfare" compared with the current situation. However, there **may be specific benefits from operating a reduced VAT in carefully targeted sectors**. Lower VAT rates can increase overall productivity and thus GDP, as well as tax revenue, in a Member State if they can induce consumers to spend less time on do-it-yourself (DIY) activities and more time on their ordinary jobs. This behaviour would result in a shift of activities from DIY to the formal economy. Locally supplied services (and restaurants) are industries where households have considerable scope for carrying out DIY and therefore the area where such a shift could thus take place. Lower VAT rates targeting sectors using many low skilled workers, such as locally supplied services, financed for example by higher VAT rates elsewhere can create permanent employment gains, but the overall gains are likely to be minor. The study **recommends that Member States carefully examine all the options available** when they want to promote the consumption of specific goods or services: often other tools than reduced VAT rates are more efficient and less costly for the State budget.

The Commission feels that there is some usefulness in applying reduced rates to locally supplied services but only where such measures are very well targeted and specific market conditions are fulfilled. It has to be stressed, nevertheless, that effects on employment remain limited. Regarding restaurant services, the study calls, on the one side, for caution as to the cross border effects of a reduced rate, as such services in some case may form part of a more global tourism sector that is open to competition between Member States, but indicates, on the other side, a rather good potential for a reduced rate to be effective.

The Commission remains convinced that the application of a single VAT rate to all goods and services would be an ideal solution from an economic point of view but recognises that policy considerations will not allow for such a simple approach. Finding the right balance between political and economic imperatives is the main issue. The Commission sets out a discussion on how to apply the results of the

study more concretely. It seeks the views of the Council, the European Parliament and other interested parties on a possible future legislative action in this field.

Taking into account the study results, it sees some merit in a new architecture for reduced VAT rates in the Community. Such approach would need to take account of the following objectives:

- the need to ensure **equal treatment** of all Member States, which means the ending of country specific derogations;
- recognition that in most Member States there is a strong political will to apply **very low reduced rates including zero rates** particularly for social purposes;
- recognition of the increased (economic and budgetary) **difficulties** for Member States **to move products from one rate category to another** because of the often very huge difference between the standard rate and a reduced rate (in most cases more than 10 sometimes more than 15 points);
- the need to **establishing a clear logic** of the purposes for which a reduced rate should be used;
- the need to **balance increased flexibility with a reduction of compliance costs**.

In a first step, the Commission would like to obtain the views from the European Parliament and the Council as to what extent they share these objectives. One of the ways to translate these objectives into more practical arrangements could be:

- to allow for a **very low rate for goods and services of first necessity** such as food. Obviously, the discussion on the scope for such a rate will be difficult (should medical treatment, social housing etc be included?) but it would offer the opportunity to limit the application of such a low rate (and its cost) to the real basic needs of citizens and thereby to exclusively social considerations;
- in addition, **a second rate could be used for other purposes** that are not basic needs but that are felt deserving of preferential treatment for other reasons (e.g. cultural and educational reasons, public transport, employment, energy and environment, etc). Such a scheme needs to remain optional to preserve Member States political choices;

to limit the cost of a three rate structure both for tax administrations and for businesses, the **categories of goods and services eligible** for different reduced rates should be **clearly defined** in order to limit difficult border-line cases; also Member States should only be able to chose a whole category for the application of a reduced rate and not only parts of it; to allow, nevertheless, a high degree of flexibility there should be a greater number of categories than today but each of them harmonised as to its content.

Further reflection on the scope of the categories within such a structure would be necessary.

Another issue relates to the effectiveness of **using VAT reduced rates for the promotion of certain goods/services**. Typical examples of currently discussed ideas to use VAT as an incentive for a particular behaviour are: energy saving materials, energy efficient products, environmentally beneficial products, biomass, healthy food etc.

The Commission takes the view that **derogations coming to an end soon should, with one or two exceptions, be temporarily prolonged until the end of 2010**, i.e. the date of expiry of the experiment on the application of reduced VAT rates to certain labour-intensive services and the most likely date of entry into force of new arrangements for reduced rates. Derogations cannot, however, be prolonged where they conflict with the proper functioning of the internal market and/or with other Community policies (e.g. derogations regarding agricultural input, or, coal, coke, fuel, oil that are contrary to energy and

environmental objectives) or where they are already covered by general provisions on rates (e.g. district heating). On the other hand, for the restaurant, food, pharmaceuticals', books and housing sectors, derogations could be prolonged as a difference in treatment would provide unequal opportunities to Member States without any substantial justification and would create unacceptable tensions. The Commission, therefore, proposes to extend most of the derogations for Member States which joined the EU after 1 January 1995.

**Conclusion:** the Commission considers that a new framework for reduced VAT rates should rationalise the use of reduced rates, create more transparency, and allow for flexibility for the Member States whilst at the same time respecting the principle set out in Article 93 of the Treaty. In the political debate, the Commission insists on the need to keep in mind that any change of a VAT rate applicable to particular goods or services, either an increase or a decrease, will impact not only on the sector concerned but also on other parts of the economy as well as on government budgets.